

REPORT OF THE AUDITOR-GENERAL TO THE COUNCIL OF MNQUMA LOCAL MUNICIPALITY AND THE EASTERN CAPE PROVINCIAL LEGISLATURE ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION FOR THE YEAR ENDED 30 JUNE 2007

Introduction

1. I was engaged to audit the accompanying financial statements of the Mnquma Local Municipality which comprise the statement of financial position as at 30 June 2007, statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, as set out on pages [xx] to [xx].

Responsibility of the accounting officer for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with Generally Recognised Accounting Practice and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and Auditor-General Audit Circular 1 of 2005. This responsibility includes:
 - designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
 - selecting and applying appropriate accounting policies
 - making accounting estimates that are reasonable in the circumstances.

Responsibility of the Auditor-General

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004), my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing. Because of the matters discussed in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis of accounting

4. The municipality's policy is to prepare financial statements on the comprehensive basis of accounting as determined by the National Treasury, as set out in accounting policy note 1 to the financial statements.

Basis for disclaimer of opinion

Accounts Receivable

5. Due to the incomplete and inaccurate billing system in place, it was not possible to confirm or alternatively test the consumer debtor's balance of R 137.5 million.
6. There was inadequate supporting documentation for the calculation of the provision for doubtful debts balance of R 132.4 million. No bad debts were written off during the period under review as explained in note 10 to the annual financial statements.
7. Consumer deposits were not collected by the municipality during the current financial year, which renders doubt over the recoverability of consumer debtors.
8. Supporting documentation for journals passed on debtors balances for debits and credits totalling R42 million and R91.9 million respectively could not be produced for audit purposes. Documentation to support the other debtor's balance of R2.9 million could not be submitted for audit purposes.

9. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on accounts receivable for the financial year ended 30 June 2007.
10. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that accounts receivable were correctly accounted for. Due to the significance of the findings above, I was unable to satisfy myself as to the existence, completeness, valuation and rights and obligations of the consumer debtors of R5.2 million (net balance) and other debtors of R2.9 million, as disclosed in notes 10 and 11 respectively, and on the face of the statement of financial position.
11. The municipality does not have a system to separately identify the value of indigent debtors, and therefore could not submit documentation and explanations in support of indigent debtor applications, approvals and monitoring requested for audit purposes. In addition the value of indigent debtors was not separately identifiable. There were no satisfactory auditing procedures I could perform to obtain reasonable assurance. As a result I was unable to satisfy myself as to the accuracy and completeness of the subsidies awarded to indigent debtors.

Revenue

12. A rentals register, with rental agreements supporting rental income of R20.8 million which has been included in property rates revenue could not be submitted for audit purposes.
13. Supporting documentation for traffic fines and cancelled traffic fines could not be obtained for audit purposes. Sequential numbering of traffic licenses and permits could not be verified. Moreover, there was no control system to ensure that revenue generated from traffic fines was deposited into the municipality's primary bank account. There were no reconciliations or schedules produced relating to traffic fines. Moreover there were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that all traffic fines income and receipts were properly recorded
14. Manual receipts issued were not recorded in the general ledger. This has resulted in the understatement of revenue. We were unable to determine the value.
15. Rates levied in respect of household improvements could not be verified as information could not be submitted for audit purposes. The valuation roll for property rates could not be reconciled to rates recognized disclosed as R38.9 million in the financial statements. A schedule detailing all land divisions, additions to properties and removals due to damage as well as a register of properties could not be submitted for audit purposes. An incomplete listing of property transfers (in comparison to tax clearance certificates provided) was provided by the municipality.
16. Grant income of R68.3 million disclosed in the statement of financial performance could not be reconciled to supporting schedules. Interest earned on external investments of R0.5 million does not agree to investment schedules provided and is not separately disclosed in the financial statements.
17. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of revenue. Journal entries have a material effect on revenue.
18. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that revenue was correctly recorded. Consequently, I was unable to satisfy

myself as to the occurrence, accuracy or completeness of revenue of R117.7 million as disclosed on the face of the statement of financial performance.

Property, plant and equipment

19. In terms of section 95(b) of the MFMA, the accounting officer should ensure that full and proper records of the financial affairs of the entity are kept. However adequate controls were not exercised over the assets during the year under review. This was as a result of asset records not being continuously and effectively monitored by management. The asset register was deficient in that it was not completely and accurately populated. The register was not adequately maintained and supported by the appropriate documentation. It was not updated for assets disposed of or stolen, as well as completed capital projects. Based on the above deficiencies and due to inadequate access to the assets, it was not possible to physically verify all assets selected for testing. The carrying amount of assets that could not be physically verified amounted to R28.6 million.
20. In addition, periodic reconciliations between the trial balance and the fixed asset register were not performed. A comparison between the fixed asset register and the annual financial statements revealed unreconciled differences amounting to R1 million. An annual impairment review of assets was not conducted. Furthermore, the backlog depreciation calculation could not be provided for audit purposes.
21. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of property, plant and equipment. Journal entries have a material affect on property, plant and equipment.
22. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on property, plant and equipment for the financial year ended 30 June 2007.
23. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that fixed assets are correctly accounted for. Consequently, I was unable to satisfy myself as to the existence or valuation of fixed assets amounting to R41.7 million as disclosed on the face of the statement of financial position.

Inventory

24. In terms of section 95(b) of the MFMA, the accounting officer should ensure that full and proper records of the financial affairs of the entity are kept. However adequate controls were not exercised over inventory during the year under review. This resulted in inventory records not being continuously and effectively monitored by management. Stationery records have not been kept. The stock count was not attended by an audit team and the municipality's stock sheets were not submitted for audit purposes. This has resulted in a limitation of scope.
25. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of inventory. Journal entries have a material affect on inventory.
26. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or

accurate and therefore I was unable to determine the effect this may have on inventory for the financial year ended 30 June 2007.

27. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that inventory was correctly accounted for. Consequently, I was unable to satisfy myself as to the existence, valuation or completeness of inventory amounting to R0.6 million as disclosed on the face of the statement of financial position.

Bank and cash

28. The municipality does not have a proper system of control over bank and cash. A register of unidentified deposits made into the municipal's bank account was not maintained and there were no reconciliations of unidentified deposits to the cash suspense accounts. Bank reconciliations were not accurately prepared and were found to have invalid reconciling items such as outstanding deposits and cheques of R0.4 million and R0.3 million respectively.
29. Call account deposits amounting to R12.9 million were incorrectly presented on the face of the statement of financial position as call investment deposits. These should be aggregated with bank balances and cash according to the requirements of the adopted accounting framework.
30. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of bank and cash. Journal entries have a material affect on bank and cash.
31. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on bank and cash for the financial year ended 30 June 2007.
32. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that bank and cash was correctly recorded and accounted for. Consequently, I was unable to satisfy myself as to the completeness, existence, valuation and classification of bank balances and cash of R0.7 million as disclosed in note 13 and the bank overdraft of R10.3 million as disclosed in note 15 of the annual financial statements.

Expenditure

33. The accounting system currently in use does not provide for a adequate and sufficient transaction trail for expenditure entries. The municipality did not submit all supporting documentation in respect of expenditure incurred as required for audit purposes. Expenses amounting to R0.3 million were recognized in the incorrect financial period, based on the date of delivery of the goods or services concerned.
34. Expenses amounting to R0.2 million were noted to have insufficient proof of delivery notes.
35. Finance leases were incorrectly classified as operating leases. The total lease expenditure included in the statement of financial performance amounted to R0.3 million.
36. Supporting schedules for grants and subsidies and repairs and maintenance paid of R13.6 million and R5 million respectively could not be submitted for audit purposes.
37. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a

limitation on the scope of the audit of expenditure. Journal entries have a material affect on expenditure.

38. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that expenditure is correctly recorded. Consequently, I was unable to satisfy myself as to the completeness, validity and accuracy of expenditure amounting to R21.3 million (an aggregate of Repairs and maintenance of R5 million, Grants and subsidies paid of R13.6 million and General expenses of R2.7 million) as disclosed on the statement of financial performance.

Value-added tax (VAT)

39. The municipality does not have a proper system of control over VAT. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of VAT. Journal entries have a material affect on VAT.
40. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on VAT for the financial year ended 30 June 2007.
41. According to the South African Revenue Services (SARS), the municipality is registered for VAT. VAT reconciliations have not been performed by the municipality for the year under review. There were no alternative auditing procedures that I could perform to obtain reasonable assurance that VAT was correctly recorded. Consequently, I was unable to satisfy myself as to the completeness, existence or valuation of the nil VAT balance as reflected in the financial statements. In addition, due to the inability to satisfactorily audit VAT I was unable to determine the value of any adjustments required to affect transactions including expenses, revenue, purchases and disposals of property, plant and equipment.

Employee costs

42. The municipality does not have a proper system of control over employee costs. The monthly payroll reconciliations were not reviewed and the salary run could not be traced to the general ledger. Wage registers were not maintained at the municipality for wage workers and supporting documentation could not be obtained for payments made to casual workers. Of the 81 employees selected for physical verification, 20 employees could not be physically verified.
43. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of employee costs. Journal entries have a material affect on employee costs.
44. I was also unable to satisfy myself as to the completeness, validity and accuracy of the amounts payable to SARS for pay as you earn, unemployment insurance fund and skills development levy amounting to R0.7 million as disclosed in note 5 of the annual financial statements.
45. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that employee costs were correctly accounted for. Consequently, I was unable to satisfy myself as to the completeness, validity and accuracy of employee costs amounting to R59.3 million as disclosed on the statement of financial performance.

Payables

46. The municipality does not have a proper system of control over payables. Contracts relating to unspent conditional grants were not submitted for audit purposes. Unspent capital grants were not separately identified in note 6 to the financial statements, and there was inadequate disclosure of capital grants in note 16, in that there was no analysis of the contents of this balance, as required by the adopted accounting framework.
47. Documentation was not submitted to support the staff loans balance of R2.3 million as disclosed in note 5 to the financial statements.
48. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of payables. Journal entries have a material affect on payables.
49. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on payables for the financial year ended 30 June 2007.
50. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that payables were correctly accounted for. Consequently, I was unable to satisfy myself as to the completeness, existence and accuracy of unspent conditional grants of R12.1 million and creditors of R8.1 million as disclosed on the statement of financial position.

Provisions

51. The municipality does not have a proper system of control over provisions, as supporting documentation for the performance bonus provision of R0.7 million was not provided for audit purposes.
52. The municipality was unable to provide all supporting documentation requested for leave taken by employees, therefore it was not possible to rely on the accuracy of the calculation of the staff leave provision. The Staff leave provision of R10 million was calculated based on leave accrued to employees in excess of forty-eight days, which is the limit set as per the agreement with the South African Local Government Bargaining Council.
53. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of provisions. Journal entries have a material affect on provisions.
54. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on provisions for the financial year ended 30 June 2007.
55. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that provisions are correctly accounted for. Consequently, I was unable to satisfy myself as to the completeness, existence and accuracy of Provisions of R10.7 million as disclosed on the statement of financial position.

Funds and reserves

56. The municipality does not have a proper system of control over funds and reserves. Documentation adequately supporting the correction of error of R110.8 million to the accumulated surplus and the off setting of depreciation adjustment of R4.3 million to the government grant reserve as disclosed on the statement of changes in net assets was not submitted for audit purposes. This was a result of ineffective reviewing, checking and reconciliation of source documentation.
57. As a result of inadequate controls instituted over journal entries, supporting documentation was not kept for any journal entries passed in the accounting records of the municipality. Supporting documentation for the journal entries selected for testing could not be submitted for audit purposes and there were no alternative procedures I could perform, resulting in a limitation on the scope of the audit of funds and reserves. Journal entries have a material affect on funds and reserves.
58. A disclaimer audit opinion was issued on the annual financial statements of the Mnquma Local Municipality for the financial year ended 30 June 2006. Therefore I was unable to determine whether the opening balances in the general ledger are complete, valid or accurate and therefore I was unable to determine the effect this may have on funds and reserves for the financial year ended 30 June 2007.
59. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that the abovementioned adjustments were correctly recorded. Consequently, I was unable to satisfy myself as to existence, accuracy and completeness of funds and reserves.

Related parties

60. There was an ineffective system in place to identify parties related to the municipality, as well as transactions and balances with such related parties. Councillors were found to have external business interests that were not disclosed in the councillor's register of interests. There were no alternative auditing procedures that I could perform to obtain reasonable assurance that related parties were correctly disclosed. Consequently, I was unable to satisfy myself as to the completeness and accuracy of related party disclosure.

Fruitless and wasteful expenditure

61. The audit revealed certain instances of fruitless and wasteful expenditure incurred by the municipality. This included a more expensive quotation being selected over less expensive ones without a valid reason, no VAT being claimed on petty cash expenditure and interest incurred on overdue accounts. However, no fruitless and wasteful expenditure was disclosed in note 31 of the annual financial statements. Management had therefore not instituted adequate controls over the identification and disclosure of fruitless and wasteful expenditure. There were no alternative auditing procedures that I could perform to obtain reasonable assurance that fruitless and wasteful expenditure was correctly disclosed. Consequently, I was unable to satisfy myself as to the completeness and accuracy of the disclosure of fruitless and wasteful expenditure.

Disclaimer of audit opinion

62. Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements of Mnquma Local Municipality for the year ended 30 June 2007. Accordingly I do not express an opinion on the financial statements.

Emphasis of matter

Without further qualifying the audit opinion expressed above, attention is drawn to the following matter:

Going concern

63. As the Mnquma Local Municipality is highly dependent on government grants, the municipality is considered to be a going concern risk. This is compounded by the bank overdraft position at year end. This overdraft is in excess of the limit set by council and has not been repaid within the agreed upon timeframe.

OTHER MATTERS

I draw attention to the following matters that relate to my responsibilities in the audit of the financial statements:

Non-compliance with applicable legislation

Municipal Finance Management Act (MFMA)

64. The following significant instances of non-compliance with the MFMA were identified:

- Section 9: The bank account details of the municipality were not communicated to Provincial Treasury during the financial year.
- Section 11: Quarterly payment reports were not tabled before council within 30 days and were not submitted to the relevant authorities.
- Section 15: The minutes evidencing that the executive mayor had tabled the budget to the council within the required 30 days, submitted for audit purposes was not signed. While budgeted employee costs for the year was R52.4 million, actual employee costs incurred was R60.3 million, which is also in contravention of this section.
- Section 45: The bank overdraft limit of R6 million as set by the council was exceeded.
- Section 52: The mayor's quarterly reports detailing financial performance were not submitted to council within 30 days of the end of the quarters.
- Section 65: Certain creditors were found not to have been paid within 30 days of the invoice date.
- Section 66: The municipality did not report to the council on staff remuneration matters according to the prescribed categories.
- Section 71: Monthly budget statements for October and December 2006 were not submitted for audit purposes and budget statements submitted for audit were not presented in the correct format.
- Section 119: The Supply Chain Manager's qualifications were not verifiable.
- Section 123: Insufficient disclosure of grant expenditure in the financial statements.

Fraud risk

65. The municipality has not taken adequate steps to detect and prevent fraud, which is highlighted by the fact that its Fraud Prevention Plan is still in a draft format. At the date of signing this audit report, ongoing forensic investigations were taking place concerning infrastructure, revenue and receivables at the municipality, the results of which have not yet been made available.

Late finalisation of the audit report

66. In terms of section 126(3)(b) of the MFMA I am required to submit my report to the Municipal Manager within three months of the receipt of the financial statements. In the interest of improving accountability and due to the process implemented by me to ensure consistency in the manner in which material audit findings are reported I have delayed the finalisation of my report to the date reflected on the audit report.

Performance management system

67. Sections 39 and 40 of the Municipal Systems Act, 2000 (Act No.32 of 2000) require the development of a Performance Management System and the establishment of mechanisms to monitor and review the Performance Management System.
68. The municipality was unable to provide evidence that the community was involved in the setting of Key Performance Indicators, as well as supporting documentation regarding the internal audit review of the performance management system. The prior period annual report was not available for audit purposes. Integrated development plan amendments were not supported by sufficient audit evidence and neither a financial plan nor investment initiative were included in the integrated development plan. It was further noted that no performance targets were set for service providers. Development priorities and objectives contained in the integrated development plan were not clear, concise and measurable and were not consistent with the performance report and budget. The integrated development plan did not identify the institutional framework which addresses the municipality's internal transformation needs.
69. There were no satisfactory auditing procedures that I could perform to obtain reasonable assurance that section 39 and 40 were complied with. Consequently, I am unable to satisfy myself as to the municipality's compliance with the Municipal Systems Act, 2000 (Act No. 32 of 2000).

Internal control

70. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The paragraphs below depict the root causes of the matters indicated, as they relate to the five components of internal control. In some instances deficiencies existed in more than one internal control component.

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
Basis for disclaimer of opinion					
Comparative figures	X				
Journal entries	X				
Accounts receivable	X				
Revenue	X		X		
Property, plant and equipment	X				
Funds and reserves	X				
Expenditure	X				
VAT			X		
Payables	X		X		
Provisions			X		
Funds and reserves	X				
Related parties	X				
Emphasis of matter					
Going concern					X

item	environment	tasks	activities	and communication
Other matters				
Non-compliance with the MFMA	X			
Fraud risk	X			X
Performance management system	X			X

OTHER REPORTING RESPONSIBILITIES

Reporting on performance information

71. In terms of section 121(3)(c) of the MFMA, the annual report of a municipality must include the annual performance report of the municipality prepared by the municipality in terms of section 46 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

Responsibility of the Auditor-General

72. I conducted my engagement in accordance with section 13 of the Public Audit Act, 2004 (Act No. 25 of 2004) read with General Notice 646 of 2007, issued in Government Gazette No. 646 of 25 May 2007 and section 45 of the MSA.

73. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

74. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

Audit findings (Performance information)

75. Based on the findings in paragraph 64, no opinion is expressed on the reported performance information as set out on pages [xx] to [xx] of the annual report.

APPRECIATION

76. The assistance rendered by the staff of the Mnquma Local Municipality during the audit is sincerely appreciated.

Gratia Generali

MTHATHA

16 July 2008

